Ist May' 2018

*Trust*Line

BizNotes

FOR PRIVATE CIRCULATION

M O N T H L Y V I E W

FROM THE FUND MANAGER DESK

Fasten your seat belts?

Early signs of acceleration seen on the economy and the good news is it can only get better!!

If things are going well, you don't hear it. That probably captures what is going on in the economy. Rural recovery can hardly match rural distress when it comes to television rating points. No one can blame you if you haven't heard rural recovery as much as rural distress. Teething problems in GST made splashy headlines, but recovery in GST collections and stabilizing e-way bill hardly make even whispers, let alone being fodder for breaking news. So is the case with the visible signs of turnaround in capex cycle, IIP numbers and so on. After long time, one gets to feel that all cylinders at last may be coming together to fire up the economic engine.

For the economy, it has been a story of chocked capex cycle for last few years. It has been running only on few cylinders (esp. consumption), while its critical capex (private investment demand) cylinder was too clogged and sputtered to lend any material support. As for the reasons, it wasn't that difficult to decipher what was at the root of so called investment inertia during that time. Over capacity and gross under-utilization in many sectors led to sharp slow-down in the need for capacity expansion and thus causing serious slump in the investment demand. Back then, the hope was that the sustained consumption demand will eventually lead to higher utilization which in turn will lead to recovery in private investments in early 2017, if not little later. But the two successive disruptions in the form of DeMon and GST dashed this hope with consumption and the broader economy coming under

MONTHLY VIEW

severe strain under these disruptions for the past 12 months.

It is now time for payoff from these disruptions. With the imprints of DeMon fading and with GST gradually gaining traction, consumption is back with vigor, leading to recovery in gross utilization numbers across sectors. Surge in order books reported by companies in the capital goods sector and the acceleration in IIP numbers in the last 3 months are the cases in point and provide evidence to early signs of recovery in investment cycle. Add to this, the optimism on monsoon, agri growth and rural recovery. All these add up as a huge ammunition for the economy to aspire for 8%+ growth sooner, may be as early as FY20, than expected earlier.

One doesn't need to go too far to find supporting evidence for the afore-said economic narrative than to have a quick look at the latest monetary policy commentary from RBI. To quote RBI,

> **"Turning to the growth outlook, several factors are expected to accelerate the pace of economic activity in 2018-19. First, there are now clearer signs of revival in investment activity as reflected in the sustained expansion in capital goods production and still rising imports, albeit at a slower pace than in January. Second, global demand has been improving, which should encourage exports and boost fresh investment. On the whole, GDP growth is projected to strengthen from 6.6 per cent in 2017-18 to 7.4 per cent in 2018-19 – in the range of 7.3-7.4 per cent in H1 and 7.3-7.6 per cent in H2 – with risks evenly balanced"**

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MONTHLY VIEW

Of course, there are macro risks like rising crude and hardening domestic yield including negative global cues such as rising bond yield in US and potential acceleration in fed rate hikes etc that could cause temporary uncertainties. That said, if luck favors a little, we are looking at huge economic tailwinds and consequently robust corporate earning cycle in the coming months for India. Coming to market, in its obsession to price the political/election risk, it has barely noticed the underlying acceleration in the corporate earning cycle. In that sense, the current lackluster drift in the market is a brilliant opportunity to nibble and accumulate (portfolio building on stock specific basis) for long-term investors who have the stomach to ride the short-term political turbulences.

Happy Value Investing!!

ArunaGiri. N

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CORPORATE NEWS

- **Tata Motors** saw its market share in commercial vehicles (CV) segment in the domestic market inch closer to 44 percent in 2017-18 riding on its turnaround strategy which aims at regaining lost ground to rivals.

- Software service firm **HCL Technologies** along with private equity firm **Sumeru Equity Partners (SEP)** has signed an agreement to acquire **Actian Corporation** for $ 330 million. While HCL Tech will own 80%, SEP will own approximately 20% stake of the joint venture which in turn will own 100% shareholding of Actian Corporation.

- Drug firm **Dr Reddy's Laboratories** said it has received establishment inspection report from the US health regulator for its Cuernavaca facility in Mexico.

- **Indian Terrain** is eyeing a 20 per cent growth for at least two years in a row as it expands retail footprint in North, East and Central India.

- **IDFC Bank** said it will raise up to Rs 50 Bn by issuing bonds in next 12 months in one or more tranches from the domestic or overseas markets.

- **Bharti Infratel Ltd** and **Indus Towers** agreed to merge their businesses to create the world's largest tower company outside China. The merger will help **Bharti Airtel Ltd, Vodafone India Ltd and Idea Cellular Ltd** easily pare their stakes in the combined entity to raise funds to invest in their telecom operations and cut debt.

- **Indoco Remedies** gets statement of GMP Non-Compliance from UK-MHRA for Goa Plant 1. MHRA statement says no evidence of product having been impacted.

- **HDFC Bank** has hiked its fixed deposit rates in select tenures for deposits under Rs 10 Mn. The new rates will yield depositors up

M O N T H L Y V I E W

to a 100 basis points higher rate, updates on the bank's website showed.

- **Kitex Garments** will form two new subsidiaries to increase the manufacturing capacities and invest Rs 2 Bn in each of them from internal accruals and borrowings.

MACRO NEWS

- Less than **200,000 e-way bills** were issued on the first day of the rollout of this anti-tax evasion measure under the goods and services tax. Around 1.1 million taxpayers and 19,800 transporters have registered on the e-way bill portal.

- With **sugarcane arrears** crossing the Rs 180 billion mark, bulk of which is from the politically sensitive state of **Uttar Pradesh**, the Centre said that it might consider levying a cess on sugar to the tune of 5 per cent, a production-linked export subsidy of about Rs 4.5 per kg and lower the GST on ethanol from the current 18 per cent to 5 per cent.

- **India's crude oil import bill** may increase 20% to $105 billion in this financial year from $88 billion in 2017-18, the petroleum and natural gas ministry has estimated, assuming average crude oil price of $65 per barrel for the year, about $9 a barrel less than the current rate.

- **Capital goods, construction firms** see 69% jump in new orders in FY18. The order flow of listed capital goods and construction companies was worth more than Rs 2.80 Tn in 2017-18 — a rise of 69 per cent over the Rs 1.65 Tn in the previous financial year.

- **The Reserve Bank of India (RBI)** adopted a remarkably dovish tone, surprising analysts who were expecting the firming up of rates in the medium term, even as one of the six members in the **Monetary Policy Committee (MPC)** voted for a hike in an otherwise status quo policy.

- In its biannual **World Economic Outlook**, **IMF** kept its GDP growth forecast for India unchanged at 7.4% for 2018-19 and

MONTHLY VIEW

7.9% for 2019-20, holding that economic activity will be lifted by strong private consumption as well as fading transitory effects of demonetisation of high-value currencies and implementation of the national goods and services tax (GST).

- **Indian exports** up to $5.6 billion could be hit as the US pressures India for greater market access by declaring a review of the **generalized system of preferences (GSP)** through which Indian exporters get preferential market access to the US.

FUNDS FLOW DATA

Data as on 24th Apr 2018		
FUNDS FLOW DATA (Rs in Cr)		
Category	***MTD***	***YTD***
FII	(4852)	8755
DII	8173	42632
Total	**3321**	**51387**

DEBT & FOREX MARKET

Data as on 25th Apr 2018			
Debt / Forex Market			
Category	***Day***	***1 Mnth***	***3 Mnths***
10 Yr Yield	7.7	7.6	7.3
Re/ US $	66.9	64.9	63.5

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MARKET VIEW*

Macro to drift, Micro to shine?

India had the best of macro during last three years. Falling crude, contained twin deficits (current account and fiscal), strengthening currency, moderate or falling yield etc dominated the economic narrative in these years. That luck seems to have run out now as we begin the next fiscal. Cracks have started creeping in the macro with much of above factors showing signs of reversal. Weakening rupee, hardening yield and rising crude have taken the sheen off the otherwise healthy macro. Add to this the heavy election cycle, one is staring at a weakening India-macro in the short-term at least. For Indian markets, macro headwinds are not limited to only domestic cues. Rising bond yields in US and potential acceleration in rate hike cycle by US Fed are some of the challenges the Indian markets have to deal with in the coming year.

But the good news is, this macro drift is unlikely to derail the carefully crafted recovery that is underway in the micro (corporate earnings growth). While macro may be losing some of its mojo, growth in the broader economy is coming back with vengeance, giving fillip to corporate earnings growth. Early signs of recovery in the investment demand (capex cycle), couldn't have come at a better time. Having said that, broader trend for the markets at the index level will continue to be muted given the macro challenges, while improvement in micro in terms of sharp recovery in corporate earnings will drive stock-specific movements in the market.

As we had highlighted in our earlier issue of BizNotes, unlike 2017, which was a year of magical macro, 2018 will be a year of micro with stock specific sizzle steered by progressive revival in the so-far elusive earnings growth. Investors should continue to focus on stock picking and portfolio construction during this dull phase of range bound market to benefit from the eventual breakout that is likely to happen as the acceleration in the economy gathers steam.

We stay away from giving market outlook (except reporting the consensus view) as we believe that the short-term market movements are function of innumerable rational and irrational parameters and hence any attempt to predict the next market move would be a futile exercise. Hence, we would like to qualify the above consensus view on outlook with a clear caution that TrustLine does not have any specific view on the outlook and does not necessarily subscribe to that.

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VALUE EXTRACTS

- In this section of the newsletter, we attach an extract/write-up that we believe can add value to the readers from the "***VALUE INVESTMENT***" point of view or others that offer interesting perspective.
- Enclosed section carries an interesting article titled ***"The Bankrupt Companies in NCLT May Revive, But You Still Lose: Monnet Ispat Edition"*** from **capitalmind.in**.

"The wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don't. It's just that simple."

- Charlie Munger

The Bankrupt Companies in NCLT May Revive, But You Still Lose: Monnet Ispat Edition

There's a steel company called Monnet Ispat which has a 1.5 million ton steel capacity. It owes banks Rs. 10,200 crore rupees. That's nearly as much as the PNB Scam, and a very large sum of money. If you put that much money in a bank, you'd earn about 700 cr. a year, or about 1.9 crores per day, or approximately Rs. 65,000 by the time you finished reading this Capitalmind article. (It's long, so you might earn even more)

And that's just the interest.

Which is exactly why Monnet Ispat went down. It couldn't pay the interest.

In 2014, Monnet got into trouble when its coal mine licenses were cancelled after a Supreme Court ruling removed all mine allocations since 1993. The loans it had were a consolidated

10,000 cr. at that time, and they couldn’t earn enough to pay the interest.

So the company’s lenders tried to do exactly what a new RBI scheme, SDR, allowed it to do. In 2015, lenders took about 51% of the company for a mere 370 cr. (converting part of the debt) Now the banks owned the majority of this steel company.

After this, they said: “What are we doing owning a steel plant? Let’s try to sell”. And then many rounds of bids later, only JSW Steel emerged with an offer, and even then the banks didn’t want it.

They went the NCLT then, taking the company into bankruptcy resolution.

And that process is now nearing its end. Meanwhile the share continues to trade, at values of Rs. 27 per share or so, jumping up and down as the resolution process continues.

There are pundits that say there’s so much value in this company! That such a lovely 1.5 million ton plan that should have so much value in the market, but the company has a market cap of just Rs. 540 cr.! Isn’t this brilliant?

The answer, to make life very boring is: **NO.**

But before that, a little background.

The Concept of Bankruptcy Resolution

When a company isn’t able to pay debt that is like your owning a house and not being able to pay back the EMI. What happens?

The bank will take over your house. Then it will sell it. Someone may come and offer them only half the amount outstanding on your loan. They might take the offer. Then, you don’t get any of your down payment or any earlier money back. You simply get nothing.

You are effectively an equity shareholder in your house. When you default, you lose all the equity that you have put in so far – and the bank takes a hit on the house loss when they sell at a lower amount. (In general, banks can still come after you for the remaining amount, but let's leave that out for now)

In a corporate bankruptcy, the concept is similar. The company can't pay its debt. So it's effectively taken over by the lenders, who then try to sell it to someone else. If that someone else pays a lot less for the company than the outstanding debt, current equity holders will get nothing (or very little).

Bankruptcy in India, under the new Indian Bankruptcy code, is a process handled by the National Company Law Tribunal (NCLT). The NCLT does this:

- Finds a guy to help "resolve" the bankruptcy, called an Interim Resolution Professional (IRP)
- The IRP is now the CEO, the big boss of the firm. Even promoters can't do anything further.
- The IRP says "Okay folks, anyone willing to buy this company? Please let me know."
- And bidders then send quotes saying "Listen I'm willing to pay this much, and in this manner, and these are my pre conditions".
- The preconditions can be complex like "I want the lenders to somehow get rid of this subsidiary before I buy" or simple, like "The pink colour in the reception area has got to go". (I'm just kidding. The pink area can stay. But the subsidiary part is more like it)
- Lenders get together and have to decide on a bidder by 270 days.
- And then, if no one's decided, the IRP puts the company into "liquidation" – that means, sell all the assets and give

the proceeds to debt holders. If anything's left, then equity holders will get something.

- If lenders agree on a buyer, they will then proceed on the buyer's bid plan.

So, in general, you have no idea how this will pan out. Existing shareholders can go to zero in a liquidation. They can see a share price fall to Rs. 1 after resolution. No one knows how it will work, and meanwhile the share continues to trade!

Let's take an example here – the proposed Monnet dilution.

Monnet Ispat's Resolution Plan: Dilute Everyone and Their Uncle

Monnet has a resolution plan that has been offered by JSW-Aion. This is:

- They'll give the banks Rs. 2650 cr. – a 75% write off from the 10,200 cr. owed.
- They'll also add about 1050 cr. as working capital and capex.

In return, all operational creditors (people who are operationally owed money, like vendors or such) get nothing. The banks get their 2650 cr. and go away. And then for equity shareholders, the structure changes.

The total amount to be organized is Rs. 3700 cr. This will be:

- Rs. 2500 cr. of debt from banks (possibly different from the current lenders)
- Loan from JSW steel of Rs. 125 cr.
- Rs. 398 cr. of new shares issued to JSW steel/Aion.
- Rs. 277 cr. of compulsorily convertible preference shares
- Rs. 200 cr. of optionally convertible preference shares.

And then the company is going to be run by the JSW/Aion combine. Great?

Well, not so much if you're a current shareholder. Remember, the stock trades at Rs. 27 or so. Let's look further.

The Massive Upcoming Dilution

So the structure currently is like this:

The Monnet Ispat Situation

Shareholder	Own?	Shares		After NCLT
JSW/Aion		0.00		75%
Lenders	47%	9.40	cr. Shares	18.75%
Promoters	25%	5.05	cr. Shares	2.98%
Others	28%	5.55	cr. Shares	3.27%
Total	**100%**	**20.00**	**cr. Shares**	

JSW/Aion is putting in Rs. 398 cr. of equity for 75%. This is the maximum that can be owned in a public company, which is why they're only doing equity for 398 cr. and the rest in compulsorily and optionally convertible preference shares.

New shares will be issued to the banks too, and take them to 18.75%.

Promoters and others will not get any new shares. They get diluted. Promoters go from 25% down to just 3%.

We can then derive how the structure works.

- The public owns 5.55 cr. shares. This is going to be 3.27% after the NCLT resolution.
- So 3.27% of what is 5.55 cr. shares? Answer: 169.6 cr. shares
- There are already 20 cr. shares.
- The company will then issue 149.6 cr. shares
- Of which 127 cr. shares go to JSW/Aion
- And the remaining go to the banks.

The Changes to Monnet			
Shareholders	**Own?**	**Shares**	
JSW	**0.75**	127.20	**cr. Shares**
Lenders	19%	31.80	cr. Shares
Promoters	3%	5.05	cr. Shares
Remaining shareholders	3%	5.55	cr. Shares
Total		**169.60**	**cr. Shares**
	Dilution	88%	

As you can see, the dilution is massive! But that’s not the end of it.

Now **for Rs. 398 cr., JSW is issued 127.20 cr. shares.**

That means **the price per share they pay is Rs. 3.13.**

Remember the stock is currently at Rs. 27 in the market, but JSW will buy in at Rs. 3.13 per share. (The market doesn’t have that much of an idea of how to value this company as it resolves)

There’s EVEN MORE dilution

Let’s just say that the convertible preference shares are also issued at the same price. So another 277 + 200 cr. is converted to shares at Rs. 3.13 per share. (This is how I would offer a deal – put the prices down right now)

This means a further 152.2 cr. shares will be issued to JSW/Aion on conversion! That’s going to result in this structure:

After Full Dilution : Monnet Ispat		
Shareholder	**Shares (cr.)**	**As %**
JSW	279.41	86.8%
Lenders	31.80	9.9%
Promoters	5.05	1.6%
Remaining shareholders	5.55	1.7%
Total	**321.81**	**100%**

Look at this carefully. We currently have 20 cr. shares. We will eventually see 322 cr. shares. That means the company will issue 150x more shares eventually, diluting existing shareholders in a big way, more than 93%.

Will Current Shareholders Make Money?

Current shareholders will own 1.7% of a fully diluted Monnet Ispat.

Current shareholders (non promoters/lenders) own about 28% of the current Monnet – which is at a market cap of Rs. 540 cr. Put another way, **current public shareholders own about Rs. 150 cr. of Monnet Ispat**.

To make any money, **Monnet Ispat has to be worth so much that 1.7% of the new entity should be worth more than that 150 cr.** (due to dilution).

And that is just to break EVEN on the current price. This is incredibly difficult – let us explain.

What can Monnet Ispat's value be?

Let's assume fantastic things happen. Monnet Ispat is revived, and it still stays public. (That's the point, really – because otherwise they would have wiped out everyone else and taken the company private, and owned all of it. Remaining public allows the promoters to sell their shares at a later point at a better valuation and also Aion, a hedge fund, to find sellers for its shares)

Monnet has a 1.5 million ton plant. JSW has about 18 million tons of capacity. So let's see what JSW is valued at and then do an appropriate adjustment.

Steel companies are valued as enterprise value (Debt plus Equity) compared to the EBIDTA they generate.

JSW Steel has a **marketcap about Rs. 73,000 cr., and net debt of 39,000 cr. for an enterprise value of 112,000 cr.**

It makes an EBIDTA of around 12,000 cr., **so the EV/EBIDTA is 9**.

At Rs. 12,000 cr. for 18 million tons pa, their EBIDTA is around Rs. 667 cr. per million tons of capacity.

Monnet has 1.5 million tons, so at the JSW efficiency, they will make and EBIDTA of Rs. 1000 cr.

The enterprise value should now adjust up to 9x EBIDTA if we are lucky – or Rs. 9,000 cr. of market cap. There's debt of Rs. 2650 cr. now, so net of that, the market cap will be Rs. 6350 cr.

For the fully diluted 321 cr. shares, that's Rs. 19.75 per share.

Monnet Ispat Valuation		
EBIDTA Ratio	6670.00	cr. Per ton
capacity	1.50	million tons
EBIDTA Estimate	1000.50	cr.
EV/EBIDTA assumption	9.00	based on JSW's
Enterprise Value	9004.50	cr.
Debt	2650.00	cr.
Equity value (market cap)	6354.50	cr.
Diluted shareholding	321.81	cr. Shares
Market value per share	**19.75**	**per share**

And that's probably after a couple years as JSW gets the efficiency going. (Remember, they have to get coal at a relatively low price, without which they can't get JSW-level metrics).

The End Game: Losing 30% From Here?

Put another way: **If you valued Monnet Ispat after all the dilution, in the best case situation, the market value per share will be Rs. 19.75 per share.**

The company might go from a market cap of Rs. 540 cr. to a new market cap of Rs. 6350 cr. – **a 12x growth – and yet, see the stock price FALL from Rs. 27 today to Rs. 19.75**.

That's the power of extreme dilution.

And that's also why getting into these NCLT bankruptcy cases is a tough case at best. Even the Monnet case has risks; if they have to buy coal at higher prices, their EBIDTA will fall substantially and they'll end up with a much lower market value.

Investing requires a margin of safety – and here in these bankrupt cases, all you have is: <u>at best, you will lose only 30% from the current price</u>.

End Note: The power of destruction

Note: JSW will do really well, of course. They, along with Aion, will have 86% of Monnet, which should give them a value of Rs. 5,500 cr. and that's a pretty neat profit to make in a few years, on a Rs. 875 cr. investment.

But that's how capitalism is supposed to be. Some people will profit because they have the ability to buy assets this cheap, in a fire sale. This is the creative power of destruction, for the incoming new shareholder.

Current shareholders, of course, see the power of capitalism in another way: Equity holders get beaten up in a fire sale – and this was a demonstration. This should serve as a warning to current shareholders of Monnet Ispat but also to those of Bhushan Steel, Amtek Auto and the like – there is unlikely to be anything on the table for them.

Article by Mr. Deepak Shenoy from capitalmind.in

Ist May’ 2018

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DISCLAIMER:

About TrustLine

At TrustLine, we run a specialized PMS fund (Portfolio Management) for exclusive set of high net-worth clients (long only value based fund). We are a company with a single mission- to deliver superior long-term returns to our clients. We are managing over Rs.350+ crores of AUM for over 375+ highly satisfied clients. This makes us among the top 20 discretionary portfolio managers in India, with industry leading performance.

Over the years we, at TrustLine, have gained rich domain expertise by focusing and specializing in Portfolio Management Services (PMS). Unlike our competition, we are a unique firm focused only on PMS. This sets us apart and gives us a competitive advantage in the PMS space. At TrustLine we believe, the quality of “Research” is fundamental to delivering out-sized returns. When research is complemented by contrarian investment approach, the rewards can be dis-proportional. This forms the foundation of our investment choices and stock selection in our core PMS business. Our disciplined practice of this “Value Investment” principle has enabled us to deliver superior risk adjusted returns with significant out-performance over bench-mark indices.

With a client retention rate in excess of 99%+, we have grown as an organization through strong references, primarily driven by solid track record of building wealth across good and bad market cycles, through focused and disciplined approach to investing.

TrustLine products include:

- ***Intrinsic*** (Deep Value fund)
- ***Intrinsic* Floater** (Arbitrage Fund)

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